Internal Revenue Service

memorandum

CC:TL-N-10476-90
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date: DEC 12 1990

to: District Counsel, San Jose W:SJ
Attn: E. Rawlins

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: San Jose District's Tip Income Project

This memorandum is in response to your September 5, 1990, memorandum requesting advice regarding the San Jose District's Tip Income Project.

ISSUES

(1) Whether the San Jose District's method of reconstructing unreported tip income satisfies the statutory and case law requirement for determining unreported tip income.

(2) Whether the San Jose District may use its method of proving tip income as a foundation upon which an employer-establishment may be assessed additional FICA tax liability pursuant to I.R.C. §§ 3101 et seq.

(3) Whether the San Jose District may assess additional federal income tax withholding liability against an employer-establishment based upon unreported tip income pursuant to sections 3401 et seq.

(4) Whether the San Jose District may assess additional FUTA tax liability against an employer-establishment based upon unreported tip income pursuant to sections 3301 et seq.

(5) Provided additional employment tax liability may be assessed against an employer-establishment, how does the San Jose District assess such liability?

CONCLUSION

We see no reason why the methods of reconstructing tip income approved in McQuatters v. Commissioner, T.C. Memo. 1973-240 and Zaharopoulos v. Commissioner, T.C. Memo. 1990-245 cannot serve as a basis for determining the employment tax liability of an employer-establishment with respect to employees who have underreported tip income. Although, in our view, the method proposed by the San Jose District is similar in nature to the methods approved by the Tax Court in McQuatters and

Zaharopoulos, we believe the method proposed by the San Jose District is flawed to the extent it relies on the cash sales amount computed pursuant to your memorandum. (This is because cash sales computed pursuant to the method will not be correct where the charged sales amount reflected on Form 8027 is less than actual total charged sales).

In determining unreported tip income, the Service must use the information on Form 8027 and from other sources to accurately determine cash sales and other relevant data. Further, the Service must be sensitive to and consider all pertinent factors in this determination. Similarly, the proposed method should possess sufficient flexibility to allow for an adjustment to the tip income amount obtained by applying the determined tip rate to the employer-establishment's cash sales, where factors suggest that the determined tip rate is not representative of the tip rate experience of all directly tipped employees.

We believe that the charged sales tips used as a basis for determining the tip rate applicable to cash sales should be representative of tips received from all cash sales. Similarly, we believe that the sample used to test the validity of data reflected on Form 8027 should be broad enough to be statistically significant and representative of total charged sales and all sales for which tips were received for the employer-establishment in question.

The absence of legislation concerning unreported tip income under the income tax withholding and FUTA provisions, as was promulgated under the FICA provisions with the amendment of section 3121(q), indicates resistance on the part of Congress to hold employers liable for these amounts. Our position is that additional FICA liability for unreported amounts of tip income may be assessed pursuant to Treas. Reg. §§ 301.6501(a)-1 and 301.6501(c)-1, provided notice and demand are given to the employer. If the employer fails to report these outstanding amounts on the quarterly Form 941 or fails to file a return, the Service may then assess the employer for the FICA tax liability. However, in light of the section 3402(k) and section 3306(s) limitation on an employer's liability for income tax withholding and FUTA taxes, respectively, to amounts reported on a written statement furnished by employees, our position is that the Service cannot assess employers additional income tax withholding and FUTA tax calculated on amounts not reported by employees.

FACTS

According to your memorandum of September 5, 1990, the facts are as follows: The San Jose District is employing a novel method of proving unreported tip income. The method is primarily based upon the employer-establishment's Form 8027, Employer's

Annual Information Return of Tip Income and Allocated Tips, as corroborated by the employer's book and records.

Specifically, under this method, a revenue agent first acquires the employer's Form 8027. As a result, before the revenue agent arrives at the audit site he or she knows the total amount of tips charged to credit cards, the total amount of charged receipts, the total amount of tips reported by both directly and indirectly tipped employees, and the total amount of receipts taken in by the employer-establishment for the year in issue. From this information, the revenue agent derives the credit card tip rate, that is, the percentage of total charged tips to total charged receipts for the year in issue.

After obtaining the credit card tip rate, the revenue agent next derives the percentage of the reported cash tips to total cash sales. This is done in three steps: first, subtracting the total charge tips (Line 1, Form 8027) from the total tips reported (Line 4c, Form 8027) to determine the total cash tips reported; second, subtracting the amount of charged receipts (Line 2, Form 8027) from the total amount of gross receipts to determine the total amount of the cash sales; and finally, dividing the total cash tips computed by the total amount of computed gross cash receipts.

The San Jose District has typically selected for audit those establishments which filed Forms 8027 that show an extreme discrepancy between the charge card tip rate and the total receipts tip rate. Briefly summarized, the audit procedures used by the District are as follows. After examining an establishment's Form 8027 and deriving the percentages described above, a revenue agent upon arriving at the audit site examines a trace sample of the employer's books and records to determine if the numbers reported on the employer's Form 8027 are consistent with those contained in the books and records. Assuming the trace sample indicates that the figures on the employer's Form 8027 are reliable, the revenue agent uses the credit card tip rate as a basis from which he or she extrapolates the cash receipts tip rate. This percentage is then adjusted downward to account for the "cash variance" and "stiff percentage" factors.

Cash Variance refers to the degree to which customers paying with cash tend to leave smaller tips than customers paying with credit cards. Stiff Percentage refers to the degree to which customers tend not to tip. Both factors are expressed in percentage terms and are derived from a variety of factors.

After being adjusted downward for cash variance and stiff percentage factors, the credit card tip rate is then applied to the employer-establishment's total cash receipts. The resulting product is then added to the charged tip income amount reported on the Form 8027 to derive the total tip income of the employer-

establishment. The reported tip income is then subtracted from the computed total tip income amount to determine unreported tip income. Upon determining unreported tip income, the FICA tax liability is then assessed against the employer-establishment based upon the amount of unreported tip income. As for the employees, the unreported tip income is allocated among serving and nonserving (directly and indirectly) tipped employees, and statutory notices of deficiency are issued accordingly.

You seek our views regarding whether the above noted method of reconstructing tip income is a reasonable method and whether this office would be willing to defend it, if it is challenged by an employer-establishment in a FICA tax refund suit. You also seek our views regarding whether the San Jose District may use its method of proving tip income as a foundation upon which an employer-establishment (typically a restaurant or hotel) may be assessed additional FICA taxes and, if so, how should the San Jose District notify an employer-establishment of its additional FICA liability. Additionally, you request our views regarding whether the San Jose District may assess an additional Federal income tax withholding liability and additional Federal Unemployment taxes against an employer-establishment based on unreported tip income. Because the San Jose District is eager to give notice to several establishments of their increased FICA taxes, you are requesting our views with regard to the matter at this time.

DISCUSSION

1. Method of Reconstructing Unreported Tip Income

Tip income is includible in gross income under I.R.C. § 61(a). Meneguzzo v. Commissioner, 43 T.C. 824 (1965). Taxpayers are required to maintain sufficient records to establish the exact amount of any tip income received. I.R.C. § 6001; Anson v. Commissioner, 328 F.2d 703, 705 (10th Cir. 1964). Where taxpayers fail to keep any records or fail to keep accurate records of their income, the Commissioner is authorized to reconstruct the income by any means the Secretary deems reasonable. I.R.C. § 446; Meneguzzo. The Commissioner's income reconstruction need not be exact, but need only be substantially correct. Additionally, the taxpayer may point out areas of specific instances in which the method used by the Commissioner fails to reflect his true income. Miller v. Commissioner, 237 F.2d 830 (5th Cir. 1956).

The Service has employed various formulas to reconstruct tip income where recordkeeping is improper or nonexistent. For example, where the amount of sales made by the particular waiter or waitress is known, the Service has determined the tip income of a particular waiter or waitress by multiplying the applicable

percentage of total tips to total sales times the total sales of the waiter or waitress. Chippi v. Commissioner, T.C. Memo. 1971-236.

Where the amount of sales made by the particular waiter or waitress is unknown, the Service has applied a determined percentage of tips to sales to the total sales in which tips were paid to estimate the total tips for all waiters and waitresses. After determining the ratio of tips to days or hours worked by or wages paid to all the waiters and waitresses at the establishment in question, the Service has determined the tip income of a particular waiter or waitress by multiplying the days or hours worked by or wages paid to the particular waiter or waitress times the determined ratio of tips to days or hours worked by or wages paid to all the waiters and waitresses. Meneguzzo; Rinaldi v. Commissioner, T.C. Memo. 1980-102.

The Service has often used a sample of the total establishment credit card or charged sales as a basis for determining the applicable percentage of tips to sales, since charged sales slips provide a record of tips per sale which is not available for cash sales. The Service's use of charged sales to establish its tip percentage and use of statistical experts to devise a random sample has been upheld by the Tax Court. Morgan v. Commissioner, T.C. Memo. 1980-499.

In McQuatters v. Commissioner, T.C. Memo. 1973-240, the Service, based on a sample two month period, determined that charge customers accounted for about one fifth of the restaurant's total sales. Additionally, the Service determined, based on the sample, that the charge tip rate was 14%. The Service reduced the 14% rate to 12% to account for the facts that cash customers usually left smaller and fewer tips than charge customers, that waitresses shared their tips with the captain, and that low tipping work like banquets was not charged. To arrive at the yearly tip income of each waitress the Service multiplied by 12% the yearly sales of each waitress. Although it reduced the tip rate from 12% to 10% to account for tip sharing with captains and other factors, the Tax Court upheld the Service's formula as logically and factually sufficient. See Review of IRS Form Letter WR79-59 (Rev. 11-79), O.M. 19192, I-297-79 (Dec. 10, 1979), which suggests that the method of reconstructing tip income upheld by the Tax Court in McQuatters is a reasonable method and supported by case law.

Formulas similar to the one approved by the Tax Court in McQuatters have been approved by the Tax Court in other cases. See e.g., Applegate v. Commissioner, T.C. Memo. 1980-497; Morgan (the Service's credit card analysis, which was devised by professional statisticians, consisted of a random sample of 12 days). Further, the Tax Court has stated that the Service, in determining the applicable tip rate, is under no duty to analyze

every charge sale made during the period in issue when the relevant data can be accurately obtained through a random sample. Morgan.

Although the Service has acknowledged that a stratified random sample is a more accurate sampling technique than a straight random sample, Burke v. Commissioner, T.C. Memo. 1985-545, the Tax Court has stated that the Service is not required to achieve a statistically precise reconstruction of an employee's tip income. Further, the Service is not required to use only accepted statistical sampling methods. Powers v. Commissioner, T.C. Memo. 1981-69. Rather, the ultimate question in omitted tip income cases is the correctness or reasonableness of the amounts determined by the Service as income received from tips viewed in the light of the record as a whole and not viewed merely in the light of a formula the Service may have used in arriving at the determined amounts. Steiner v. Commissioner, T.C. Memo. 1963-143; Saukerson v. Commissioner, T.C. Memo. 1975-188.

Although finding the formula used by the Service to determine tip income to be reasonable, a court may nevertheless find it necessary to make adjustments in the application of the formula and/or to reduce the tip percentage determined by the Service to take into account various factors. This may occur where, for example, the Service's formula did not consider that cash customers usually leave smaller and fewer tips than charge customers or that waiters or waitresses shared tips with busboys or restaurant captains or where the Service's formula failed to reflect the type of establishment in question or the tipping practices of the various categories of customers who patronized the establishment. Chippi v. Commissioner; Shieman v. Commissioner, T.C. Memo. 1980-427. Similarly, the tip rate based upon credit card or charged sales might not be truly representative of the rate of tipping in all sections of an establishment and/or at the time the employee in question was working. Thiel v. Commissioner, T.C. Memo. 1977-387.

We believe, if the information reflected on Form 8027 is accurate, that use of such information to determine unreported tip income is reasonable. We believe this view is supported by Zaharopoulos v. Commissioner, T.C. Memo. 1990-245. In Zaharopoulos, the Service determined the total tip income of a restaurant by adding 10% of cash sales to the charged tip amount reflected on Form 8027. After computing each employee's allocable share of total tip income, the Service determined each employee's unreported tip income by subtracting the tip income reported by the employee from the employee's allocable share of total tip income. The Tax Court concluded that the method used by the Service to determine unreported tip income was not unreasonable and was the most realistic method that could have

been used with the information available. In so concluding, the Tax Court rejected petitioner's contention that certain figures on Form 8027 were incorrect.

We believe the method proposed by the San Jose District is similar in nature to the methods approved by the Tax Court in McQuatters, Zaharopoulos, and other tip income cases. This is because the proposed method uses charged sales and tips as the basis for determining the applicable percentage of tips to sales. Further, a sample of credit sales is tested in order to verify that the amounts of charged sales and tips reflected on the Form 8027 are correct and adjustments are made to the charge tip rate to account for cash variance and stiff percentage factors in arriving at the tip rate applicable to cash sales. Although the methods approved in McQuatters, Zaharopoulos, and other tip income cases have been used historically to ascertain the unreported tip income of employees for income tax purposes, we see no reason why similar methods cannot serve as a basis for determining the potential employment tax liability of an employer with respect to employees who have underreported tip income.

With respect to the San Jose District's method of determining underreported tip income, we have concerns regarding the proposed use of Form 8027 to determine cash sales and the cash tip rate. This is because we disagree with the suggestion in your memorandum that cash sales for an employer-establishment can be obtained by subtracting charged receipts on which there were charged tips (Line 2, Form 8027) from the total amount of gross receipts. Because Line 2 of Form 8027 reflects only the charged receipts showing charged tips and not total charged receipts, the difference between the charged sales amount on Line 2, Form 8027 (where such amount is not the same as the total charged sales amount) and gross receipts does not yield the correct amount of cash sales.

Because cash sales computed pursuant to your memorandum will not be correct where the charged sales amount on Line 2, Form 8027 is less than total charged sales, the proposed formula also cannot yield reliable data, based on cash sales, for purposes of determining the cash tip rate, the cash variance, and the extent of the discrepancy between the cash and charge tip rate. As a result, we believe the formula proposed by the San Jose District to determine tip income is flawed to the extent it relies on the cash sales amount computed pursuant to your memorandum.

We believe it is reasonable, however, that the proposed method for determining tip income takes into account cash variance and stiff percentage factors. Further, because in our view it is a prerequisite that unreported tip income giving rise to employer employment tax liability be traceable to the employees whose underreporting gave rise to the liability, we also believe it is proper that the method calls for an

appropriate allocation of unreported tip income between directly and indirectly tipped employees. Nevertheless, for the proposed method to be viewed as valid overall, we believe the Service must look not only to Form 8027 but also to other sources to obtain the information necessary to accurately determine cash sales and other relevant data based thereon. Further, we believe that if the Service is going to determine an employment tax liability against the employer-establishment with respect to unreported tip income, the Service should be prepared to issue a statutory notice of deficiency to the employees whose unreported tip income gives rise to the employment tax liability.

Aside from addressing the concerns noted, we recommend that in determining the unreported tip income of each employee the Service be sensitive to and consider pertinent factors that might suggest that the determined tip rate based generally on Form 8027 data might not be truly representative of the rate of tipping in all sections of an establishment or at the time a particular employee was working. See O.M. 19192. Likewise, we recommend that the proposed method possess sufficient flexibility to allow for an adjustment to the tip income amount obtained by applying the determined tip rate to the employer-establishment's cash sales, where factors suggest that the determined tip rate is not representative of the tip rate experience of all directly tipped employees.

We recommend that the charged sales tips used as the basis for determining the tip rate applicable to cash sales be sufficiently significant to be representative of tips received from all cash sales. Similarly, because the information on the face of Form 8027 will serve as a basis for determining the applicable tip income rate, we believe the validity of the information on Form 8027 should be carefully tested. Although it is not necessary that the Service use a statistically precise sample in testing the validity of the information, we recommend that the sample used for testing purposes be broad enough so as to be statistically significant and representative of the total credit sales and total tip sales of the employer-establishment in question.

Employment Tax - Introduction

As noted above, we have concerns regarding certain aspects of the San Jose District's method of reconstructing tip income. Nonetheless, we believe that modification of the proposed method can yield a method that satisfies the statutory and case law requirements for determining unreported tip income. Thus, the discussion that follows, which addresses the issues concerning assessment of additional employment tax liability based upon the reconstructed tip income, is based on the assumption that the San Jose District's method will be appropriately modified and will

satisfy the statutory and case law requirements. The following discussion was coordinated with the Office of Associate Chief Counsel (Technical) and they agree with our conclusions.

Tip income received by an employee in the course of employment is generally taxable for social security purposes to both an employer and employee. I.R.C. § 3121(a)(12)(B); Treas. Reg. § 31.3102-3. Cash tips received by an employee in the course and scope of employment are subject to FICA tax provided the aggregate amount of tips received in a calendar month is greater than $20. I.R.C. § 3121(a)(12)(B). Cash tips include both tips that are received directly from customers and those that the customer charges. I.R.C. § 3401(a)(16)(B); Treas. Reg. § 31.3121(a)(12)-1; Rev. Rul. 76-231, 1976-1 C.B. 378, superseding Rev. Rul. 75-400, 1975-2 C.B. 464 and amplifying Rev. Rul. 69-28, 1969-1 C.B. 270.

Section 6041 provides, in part, that persons engaged in a trade or business and making payment in the course of such trade or business to another person, of salaries, wages, compensations, remunerations, or other fixed or determinable income of $600 or more in any taxable year, shall file a return under such regulations and in such form and manner and to such extent as prescribed by the Secretary. See also, Treas. Reg. § 1.6041-2(a).

Section 6051(a) provides in the case of tips received by an employee in the course of employment, that the amounts required to be shown as "wages" under sections 3401(a) and 3121(a) shall include only such tips as are included in statements furnished to the employer pursuant to section 6053(a).

Section 6053(a) provides, in part, that every employee who, in the course of employment by an employer, receives in any calendar month tips which are wages (as defined in section 3121(a) or section 3401(a)), shall report all such tips in one or more written statements furnished to the employer on or before the 10th day following such month. Treas. Reg. § 31.6053-1.

Treas. Reg. §§ 31.3121(q)-1 and 31.3401(f)-1 provide that tips reported by an employee to the employer in a written statement furnished to the employer pursuant to section 6053(a), shall be deemed to be paid to the employee at the time the written statement is furnished to the employer. These sections also provide that tips received by an employee that are not reported to the employer in a written statement furnished pursuant to section 6053(a) shall be deemed paid to the employee at the time the tips are actually received by the employee.

"Wages" are defined under section 3121(a)(12) to include tips except for noncash tips and tips of $20 or less in a given month. Tips are considered to be received by an employee in the

course and scope of employment whether paid directly from the employer, or from a person other than the employer. Treas. Reg. § 31.3121(q)-1(c). Thus, where employees practice tip splitting (e.g. waiters pay a portion of the tips received to the busboys), each employee who receives a portion of the tip is considered to have received tip income in the course and scope of employment. Rev. Rul. 76-231 and Rev. Rul. 69-28, 1969-1 C.B. 270, amplified by Rev. Rul. 76-231. In addition, service charges (a flat percentage applied to the bill by the employer for tip purposes) imposed by an employer-establishment which are paid to employees are considered to be "wages" paid by the employer and are subject to both FICA and FUTA taxes. Rev. Rul. 69-28, 1969-1 C.B. 270.

2. Assessment of Additional FICA Tax Liability

Prior to 1988, section 3121(q) excluded tip income from the employer's portion of FICA (except to the extent the wages paid by the employer were less than the minimum wage specified in the Fair Standards Labor Act as per the requirements of section 3121(t) which was repealed by P.L. 100-203, § 9006(b)(2)). However, under the Omnibus Reconciliation Act of 1987 (P.L. 100-203, § 9006), the full amount of an employee's tips are now subject to both employer and employee portions of the FICA tax. I.R.C. § 3121(q). Section 3121(q) now provides with respect to tips received after January 1, 1988, that tips received by an employee in the course of employment shall be considered remuneration for such employment (and deemed to have been paid by the employer for purposes of (a) and (b) of section 3111). Such remuneration shall be deemed to have been paid at the time a written statement including such tips is furnished to the employer pursuant to section 6053(a) or, if no statement including such tips is furnished, at the time received; except that, in determining the employer's liability in connection with the taxes imposed by section 3111 with respect to such tips where no such statement is furnished (or to the extent the statement is incomplete or inaccurate), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand (not to be confused with notice and demand as required under section 6303) for such taxes is made to the employer by the Secretary.

The authority for the Service to assess additional FICA tax against an employer-establishment for unreported tip income has its genesis in section 3121(q). The amendment of this section in 1987 now allows the Service to assess additional FICA liability against an employer (for the employer's portion of this liability) with respect to tips where no statement reporting such tips was furnished by an employee (or to the extent the statement is inaccurate or incomplete). This additional tax liability is determined based upon remuneration deemed paid on the date notice and demand is made to the employer by the Secretary.

Thus by statute, the San Jose District must issue a notice and demand to the employer once a determination of the amount of unreported tip income is made. The employer must report these amounts on the quarterly Form 941 for the quarter in which notice and demand is made. Should the employer fail to report the amounts for which notice and demand were given, only then may the Service assess the employer for the FICA tax liability. Essentially, the additional assessment of FICA liability under section 3121(q) hinges upon notice and demand being given to the employer. Therefore, our position is that an employer is not liable for prior FICA taxes until notice and demand is made by the Service for these amounts. For assessment of the FICA tax amounts determined to be outstanding, assessment is made after a return is filed by the employer, or if no return is filed, after the due date prescribed for filing the return has passed. Treas. Reg. §§ 301.6501(a)-1 and 301.6501(c)-1. See also, section 6501 for statute of limitations requirements concerning assessments.

3. Assessment of Additional Withholding Tax Liability

For purposes of income tax withholding liability, section 3401(f) provides that the term "wages" includes tips received by an employee in the course of employment. Such wages shall be deemed received at the time a written statement including such tips is furnished to the employer pursuant to section 6053(a) or (if no statement including such tips is so furnished) at the time received. Section 3402(k) provides that in the case of tips that constitute wages, subsection (a) (amounts subject to income tax withholding) shall be applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053(a), and only to the extent that the tax can be deducted and withheld by the employer.

Prior to the publication of Rev. Rul. 76-231, employers were not withholding on full amounts paid to employees as tips from credit or charged sales. Employers were only withholding on the amount of tip income furnished on statements by employees. Pursuant to sections 3401 et seq. and the reporting requirements of section 6041, employers were only required to report the amounts of tip income from charged sales which were furnished on statements by employees. Therefore, tip income which was not being reported on the statements furnished to employers was escaping taxation.

Rev. Rul. 76-231 was published to combat the underreporting of tip income in this respect. This ruling provides that tip amounts received by employers and paid over to employees for charge customers must be reported by the employer on Form W-2 regardless of whether the employee reports such tips to the employer. The ruling addresses several situations involving tips from charge customers (i.e. tip splitting or pooling arrangements) and requires that all tip income received from

charged sales which is not reported on statements furnished by employees, must be reported by employers on the Form W-2 as unreported tip income. This allows the Service to better track tip income from credit sales and assess tax liability against employees for tips not reported.

The Service stated that this additional reporting requirement set forth in Rev. Rul. 76-231 would not impose any undue hardship or burden upon employers since employers had the charge slips in their possession and could trace the tip income to specific employees. However, there is no authority which requires employers to document cash tip income received by employees, other than the reporting requirements under section 6053(a). There is no provision providing authority, similar to that set forth under section 3121(q) of FICA, which allows the Service to assess additional withholding liability for unreported amounts of cash tip income. Section 3402(k) specifically provides that an employer's liability is limited to amounts which are reported on statements furnished by employees pursuant to section 6053(a). Therefore, it is our position that an employer cannot be assessed additional withholding liability for cash tip amounts not reported by employees pursuant to section 6053(a).

4. Assessment of Additional FUTA Tax Liability

Section 3306(s), added by § 1073, P.L. 98-369, effective with respect to tips received on or after January 1, 1986, essentially provides that for FUTA tax purposes the term "wages" includes all tips received while performing services which constitute employment and are included in a written statement furnished to the employer pursuant to section 6053(a). Again, reportable tips are limited to cash tips of $20 or more received by an employee in a calendar month. I.R.C. § 3121(a)(12)(B). Cash tips include both tips that are received directly from the customer and those the customer charges. I.R.C. § 3401(a)(16)(B); Treas. Reg. § 31.3121(a)(12)-1; Rev. Rul. 76-231. Tip income subject to FUTA tax is reported on Form 940 in the same manner as any other payment of wages.

The provisions under FUTA do not provide authority allowing the Service to assess additional tax liability against an employer based upon the amounts of unreported cash tip income. The conjunctive requirements of section 3306(s) limit the FUTA liability of an employer to amounts reported by employees on written statements pursuant to section 6053(a). Therefore, there is no authority which allows the Service to assess additional FUTA amounts based upon unreported tip income.

5. Procedure for Assessing Additional Tax Liability

The last issue concerns the proper procedures to be utilized by the San Jose District to give notice and demand to an employer for additional FICA taxes.

Ordinarily in the situation where an employee's tip income is reconstructed, waiver forms are given to the employer and employee for purposes of assessment. The employment taxes based upon the reconstructed income are then assessed. The Service then gives notice and demand to the employee for the assessed taxes for collection purposes.

However, when approaching an employer for FICA taxes determined to be outstanding pursuant to section 3121(q), the ordinary procedures may not be utilized. We have coordinated this issue with National Office Examination Division and they have informed us that once the Service determines that an employer owes FICA taxes for previous quarters, the employer must then be given notice and demand (either orally or written) in the current quarter to report and pay the FICA tax liability on its upcoming Form 941. Only after the return date for filing the quarterly return has passed may the Service audit the employer. Then the Service can utilize normal assessment procedures for the FICA taxes owed for that quarter and the amounts required to be reported and paid for the quarters for which notice and demand were given. We note that for assessment purposes, a Form 2504 should be used. This is a waiver form, signed by the employer, allowing assessment of the additional FICA taxes. The rates applicable for the quarters in issue are 1990 rates (or the rates applicable in future years) since notice and demand must be made in this tax year or future years.

We note that this memorandum should not be circulated beyond the Office of Chief Counsel. Specifically, a copy should not be made available to the San Jose Examination Division. Further, neither a potential taxpayer nor its counsel should receive a copy or even be made aware that Tax Litigation Advice was requested. CCDM (35)8(12)7.

We also note that any such potential taxpayer may have a right to request technical advice from the Associate Chief Counsel (Technical) pursuant to the provisions of Rev. Proc. 90-2, 1990-1 I.R.B. 38. We do not wish to compromise such taxpayer's rights should the consideration by the Appeals Division or Examination Division result in an adverse determination.

If you have questions concerning the above discussion or if you need further assistance regarding this matter, please contact Willie E. Armstrong, Jr. at FTS 566-3335 or Richard L. Overton at FTS 566-3470.

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